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An Intervention Requirement Provides Greater Benefit to the Corporation When Nonparty Shareholders Appeal Derivative Action Settlements: *Felzen v. Andreas*, 134 F.3d 873 (7th Cir. 1998)

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I. INTRODUCTION

When a corporation has a legal problem, its board of directors will normally decide to take a course of action that it feels is in the corporation’s best interest. Sometimes this means litigation, while other times it means simply ignoring the problem. In some situations, however, the course of action that the board of directors decides to pursue may not be in the corporation’s best interests. This often arises when
directors breach a fiduciary duty to the corporation.\textsuperscript{1} When this occurs, the corporation will have a claim against the directors. The problem with this situation is that the same directors who breached their duty simultaneously control the corporation, so it is unlikely that they will decide to bring an action against themselves. For these special situations the law has created a mechanism that allows a shareholder to instigate an action on behalf of the corporation. Essentially, "[a] shareholder-controlled derivative suit is a usurpation of the directors' normal power to manage the business and affairs of a corporation justifiable only in circumstances where the directors are unable or unwilling to handle the litigation in the best interests of the corporation."\textsuperscript{2}

To understand the significance of an appeal of a derivative suit, it is first necessary to understand the derivative suit itself. The structure of the derivative suit is rather unusual. "In its classic form, a derivative suit involves two actions brought by an individual shareholder: (i) an action against the corporation for failing to bring a specified suit and (ii) an action on behalf of the corporation for harm to it identical to the one which the corporation failed to bring."\textsuperscript{3} Since the shareholder takes action on behalf of the corporation, any recovery will go to the corporation rather than the specific shareholder bringing the action. As Judge Winter more elegantly put it in *Joy v. North*:\textsuperscript{4}

\[\text{[T]he shareholder plaintiffs are quite often little more than a formality for purposes of the caption rather than parties with a real interest in the outcome. Since any judgment runs to the corporation, shareholder plaintiffs at best realize an appreciation in the value of their shares. The real incentive to bring derivative actions is usually not the hope of return to the corporation but the hope of handsome fees to be recovered by plaintiffs' counsel.}\textsuperscript{5}

The court went on to state:

Since very few shareholders would pay an attorney's fee out of their own pocket to finance a suit that is brought on the corporation's behalf and normally holds only a slight and indirect benefit for the plaintiff, very few derivative actions would be brought if the law did not allow the plaintiff's attorney to be compensated by a contingent fee payable out of the corporate recovery.\textsuperscript{6}

Thus, the role of the plaintiff's attorney is very important in derivative actions.

While derivative actions would rarely be brought without plaintiffs' attorneys, the fact that plaintiffs' attorneys bring the actions also causes a major problem. As many courts and commentators have pointed out, "[o]ne of the risks flowing from shareholders' difficulty in

\begin{enumerate}
\item Id. at 397.
\item 692 F.2d 880 (2d Cir. 1982).
\item Id. at 887.
\item Id.
\item Id. (quoting Cary & Eisenberg, Corporations 938 (5th ed. 1980)).
\end{enumerate}
monitoring derivative litigation is that plaintiffs’ counsel and the defendants will structure a settlement such that the plaintiffs’ attorneys’ fees are disproportionate to any relief obtained for the corporation.”

Derivative litigation brings with it a risk that a plaintiff’s attorney will settle on an agreement that provides little benefit to the corporation but provides high fees for herself.

The law has, however, created a mechanism that helps to ensure that the settlement agreements are fair and reasonable. Federal Rule of Civil Procedure 23.1 requires the court to approve the settlement and to give notice of the proposed compromise or dismissal to the shareholders. This notice not only informs the shareholders of the pending litigation and terms of the settlement, but also provides the shareholders with a chance to object to the settlement at the settlement hearing. Once notice is given, shareholders that disapprove of the settlement have the option to voice their objections to the court. After hearing the shareholders’ objections, the court will then determine whether to approve the settlement.

7. Bell Atl. Corp. v. Bolger, 2 F.3d 1304, 1310 (3d Cir. 1993); see, e.g., Felzen v. Andreas, 134 F.3d 873, 876 (7th Cir. 1998); Jeffrey Michael Smith, Note, The Role of the Attorney in Protecting (and Impairing) Shareholder Interests: Incentives and Disincentives to Maximize Corporate Wealth, 47 DUKL J. 161, 176-77 (1997) (“The decisions made by the entrepreneur-attorney, both before and after the suit has been filed, reflect the attorney's own interests and not those of the client.”).

8. See Kaplan v. Rand, 192 F.3d 60, 71 (2d Cir. 1999); Bell Atl. Corp., 2 F.3d at 1310; 5 JAMES WM. MOORE, MOORE'S FEDERAL PRACTICE § 23.1.10121 [a] (3d ed.) (“Derivative actions pose the inherent risk that the representative plaintiff will collude with the defendant to forego the derivative claims in exchange for a settlement that is only favorable to the representative plaintiff and his or her attorneys.”).


10. See Bell Atl. Corp., 2 F.3d at 1309 n.9 (stating that most shareholders are not even aware of the litigation until they receive the notice of the settlement or dismissal).

11. Although not specifically mandated by Rule 23.1, it is common practice among the courts to invite the shareholders to the settlement hearing so that they may present any objections they have to the proposed settlement. See, e.g., Bell Atl. Corp., 2 F.3d at 1307. While analyzing the notice requirement of Rule 23(c), which was the predecessor to Rule 23.1, the court in Cohen v. Young, 127 F.2d 721 (6th Cir. 1942), stated:

The rule provides for notice to stockholders not only in order that they may have the right to be heard but also in order that the court may have the benefit of that broader information which comes from receiving advice as to the views of all parties concerned and from considering evidence proffered by them upon the relevant points of the case. In other words, the rule was adopted to secure not routine approval of a consent decree, but in order to insure supervision of the court for the protection of the corporation and all the stockholders.

Id. at 725.

12. See Kaplan, 192 F.3d at 67; Bell Atl. Corp., 2 F.3d at 1307; Cohen, 127 F.2d at 724.
When the court approves the proposed settlement over the non-party shareholders' objections, some shareholders may try to appeal that decision. The question then arises whether a shareholder who has not been formally made a party to the action by intervening under Federal Rule of Civil Procedure 24, but who has appeared, pursuant to court notice, to voice his objections to the proposed settlement, may appeal the district court's approval of the settlement reached between the named parties.

This note argues that the Seventh Circuit's recent holding in *Felzen v. Andreas*, which was affirmed by an equally divided Supreme Court, and which requires nonparty shareholders to intervene before they will be allowed to appeal, will result in the most benefit to the corporation. Before reaching this conclusion, however, Part II will review not only *Felzen*, but the case law leading up to it and one case that was decided after it. Part III will then describe the two main problems that result from class and derivative actions and will set forth and explain the argument of this note: that the rule requiring intervention provides the best solution to these problems. Part IV will provide further support for this conclusion by illustrating how it will benefit the corporation.

II. BACKGROUND

A. Before *Felzen*

1. Class Actions

Although this analysis focuses on nonparty appeals of derivative actions, how courts have handled the appeals of unnamed class members is particularly relevant to determining whether nonparty shareholders should be required to intervene before they will be allowed to appeal a district court's approval of a settlement agreement. In fact, when determining whether a nonparty shareholder may appeal without intervening, many courts have not even distinguished between the two actions. In addition, since the two actions involve the same problems, how the courts have handled these problems in the class action setting is instructive.

In *Research Corp. v. Asgrow Seed Co.*, the Seventh Circuit decided the first of what would become a line of related cases leading to its recent decision in *Felzen*. There, the plaintiff brought a patent infringement action, naming six companies as defendants and repre-

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13. 134 F.3d 873 (7th Cir. 1998).
16. See infra Part III.A.
17. 425 F.2d 1059 (7th Cir. 1970).
sentatives of a class of alleged infringers. Eventually, the plaintiff reached a settlement with the named defendants. After a hearing during which the appellants, who were unnamed class members, made no objections, the court entered a consent judgment. Dismissing the appellants’ appeal, the court stated that “[i]f a class member intervenes or even appears in response to a notice pursuant to Fed. R. Civ. P. 23(e) and objects to the dismissal or compromise, he has a right to appeal from an adverse final judgment.” Significantly, however, the court mentioned in a footnote that the appellants’ failure to intervene after receipt of notice before the final judgment foreclosed their right to appeal. Recognizing the inconsistency of the two positions taken by the court, subsequent courts reviewing the judgment have ignored the footnote.

The Seventh Circuit reaffirmed its holding in Research Corp. in two subsequent cases. The first case was Patterson v. Stovall, where the issue was whether the district court abused its discretion in approving the settlement agreement reached between the parties. The appellants in that case were unnamed class members who had objected to the settlement in the district court. In a footnote, the court noted that “there is no doubt that the objectors have standing to appeal.” Similarly, in Armstrong v. Board of School Directors, the court stated that the right of a class member to appeal “exists independent of any motion made in the district court.”

The Third Circuit reached a similar result in Ace Heating & Plumbing Co. v. Crane Co. This case was unique in that the class members were given the opportunity to decide whether to join the class after they were informed of the substantial terms of the settlement. The court recognized that “[o]rdinarily, aggrieved class members may appeal any final order of a district court in proceedings held

18. See id. at 1059.
19. Id. at 1060 (citations omitted).
20. See id. at 1060 n.2.
21. See Felzen, 134 F.3d at 875; Croyden Assocs. v. Alleco, Inc., 969 F.2d 675, 679 (8th Cir. 1992) (“Later cases have ignored this footnote and have relied on the text of Research Corp. to perpetuate the rule that an unnamed class member-objector may appeal from a class action judgment.”); Armstrong v. Board of School Directors, 616 F.2d 305, 327 (7th Cir. 1980) (stating that in Research, “this court held that an unnamed class member who appears in response to a Rule 23(e) notice and objects to a settlement has a right to appeal from an adverse judgment”).
22. 528 F.2d 108 (7th Cir. 1976).
23. See id. at 109.
24. Id. at 109 n.1.
25. 616 F.2d 305 (7th Cir. 1980).
26. Id. at 327.
27. 453 F.2d 30 (3d Cir. 1971).
pursuant to Rule 23." Even in this unusual situation, the court upheld that rule. It recognized that where potential class members may elect to join the class knowing the settlement terms, there may be less of a need to police settlements. Nonetheless, the court also recognized that small claimants might not have a real choice regarding whether to join the class since "many small claimants frequently have no litigable claims unless aggregated." Thus, unless allowed to appeal, they would be faced with a no-win situation — either opt out and receive nothing or join the class and be stuck with an unfair settlement. Accordingly, the court held that even in this situation, a class member had the right to appeal.

The Ninth Circuit addressed whether a class member could appeal the district court's approval of a settlement agreement in Marshall v. Holiday Magic, Inc. After first determining that the appellants were class members, the court stated that, as such, their legal rights were "affected by the settlement and they have standing to sue." In support of its holding, the court cited Ace Heating. Although objections were filed in opposition to the settlement, it appears that none were filed by the appellants. Accordingly, the Marshall court's conclusion could be read to extend not only to those parties who objected to the proposed settlement, but also to those who did not. The holding in Ace Heating appears to be equally unrestrained.

In 1987, the Eleventh Circuit decided Guthrie v. Evans. This case has become the foundation upon which a number of subsequent courts have based their decisions. Additionally, it marks a distinct turning point in the previous trend of allowing objecting class members to appeal a district court judgment without intervening. In

28. Id. at 32.
29. See id. at 32-33.
30. Id. at 33.
31. See id.
32. See id.
33. 550 F.2d 1173 (9th Cir. 1977).
34. Id. at 1176.
35. See id.
36. 815 F.2d 626 (11th Cir. 1987).
37. See Gottlieb v. Wiles, 11 F.3d 1004, 1008 (10th Cir. 1993) (setting out and applying the Guthrie test); In re VMS Ltd. Partnership Sec. Litig., 976 F.2d 362, 368 (7th Cir. 1992) ("[W]e find Guthrie's analysis persuasive where an unnamed class member ... is appealing a post-settlement order implementing the settlement agreement."); Croyden Assocs., 969 F.2d at 680 ("We believe that Guthrie and Walker are persuasive authority and we see no decision that has pointed to a flaw in their analysis."); Walker v. City of Mesquite, 858 F.2d 1071, 1073-74 (5th Cir. 1988) (stating that the court was persuaded by the reasoning in Guthrie). But see Shults, 35 F.3d at 1061 (recognizing Guthrie's reasoning, but allowing some exceptions).
38. See Shults, 35 F.3d at 1059 (noting that Guthrie is "the case that appears to be the progenitor of the modern trend in the federal courts" in cases where unnamed
Guthrie, an unnamed class member in a class action challenging the confinement conditions at Georgia State Prison appealed the district court’s final judgment, which permanently enjoined the defendants from violating prior orders of the court. The court, addressing this issue for the first time, held that there were three reasons why an unnamed class member who had not intervened did not have standing to appeal a final district court judgment that was binding on the class members.

First, the court did not find that the appellant would fairly and adequately represent the class. Since Federal Rule of Civil Procedure 23(a) requires a finding by the district court that a representative of the class will “fairly and adequately protect the interests of the class,” and since this determination had not been made regarding the appellant, he had “no standing to take any action on behalf of the class.”

Second, there are other avenues of relief for an unnamed class member who disagrees with the course of the class action. The court recognized three such avenues. First, a class member could intervene as of right pursuant to Rule 24(a)(2) of the Federal Rules of Civil Procedure. This, the court stated, would allow class members to “monitor the representation of their rights.” The court also recognized that a denial of a motion to intervene of right is appealable. Second, if an unnamed class member was not adequately represented by the class representative, she would be able pursue relief in a collateral proceeding. Finally, although not applicable to a Rule 23(b)(2) action, which was the type of action before the court, a class member in a Rule 23(b)(3) action may opt out of the class. By opting out of the class, a class member will not be bound by the litigation or the final judgment.

Third and finally, “allowing direct appeals by individual class members who have not intervened in the district court would defeat the very purpose of class action lawsuits.” To reach this conclusion,
the court recognized that the "fundamental purpose" of the class action is to allow the efficient resolution of a large number of similar suits that would otherwise be resolved on a case-by-case basis.\textsuperscript{49} Similarly, "[i]f each class member could appeal individually, the litigation could become unwieldy."\textsuperscript{50}

The decision of the Supreme Court in \textit{Marino v. Ortiz},\textsuperscript{51} like \textit{Guthrie}, has also had a significant impact on subsequent cases.\textsuperscript{52} However, in spite of how some courts have interpreted \textit{Marino}, it did not decide whether an unnamed class member or a nonparty shareholder could appeal a consent decree entered by the district court without first intervening. Rather, the Court determined whether strangers to an action who had objected to the approval of the settlement could appeal without first intervening.\textsuperscript{53} Groups representing minority members who had passed a police sergeant's examination at disproportionately low rates brought a Title VII lawsuit against the New York City Police Department.\textsuperscript{54} After several groups intervened in the action, the parties reached a settlement that the court then approved. The petitioners were a group of white police officers who had objected to the settlement at the hearing, but did not attempt to intervene. The Court held that since they were not parties to the underlying lawsuit and did not intervene, they could not appeal: "The rule that only parties to a lawsuit, or those that properly become parties, may appeal an adverse judgment is well settled."\textsuperscript{55} The Court then went on to state that in spite of the exception recognized by the Court of Appeals, namely, that a nonparty may appeal if he has an interest that is affected by the judgment of the trial court, "the better practice is for such a nonparty to seek intervention for purposes of appeal; denials of such motions are, of course, appealable."\textsuperscript{56}

Approximately twenty-two years after its decision in \textit{Research Corp.}, the Seventh Circuit faced a similar question in \textit{In re VMS Limited Partnership Securities Litigation}.\textsuperscript{57} This time, however, instead of considering whether an unnamed class member who had not intervened could appeal the district court's consent decree approving a settlement agreement, the court considered whether an unnamed class member who had not intervened could appeal the district court's post-

\textsuperscript{49} See id.
\textsuperscript{50} Id.
\textsuperscript{51} 484 U.S. 301 (1988).
\textsuperscript{52} See, e.g., Felzen v. Andreas, 134 F.3d 873, 874 (7th Cir. 1998); \textit{In re VMS Ltd. Partnership Sec. Litig.}, 976 F.2d 362, 366 (7th Cir. 1992); Walker v. City of Mesquite, 858 F.2d 1071, 1074 (5th Cir. 1988).
\textsuperscript{53} See \textit{Marino}, 484 U.S. at 304.
\textsuperscript{54} See id. at 302-03.
\textsuperscript{55} Id. at 304.
\textsuperscript{56} Id.
\textsuperscript{57} 976 F.2d 362 (7th Cir. 1992).
settlement order implementing the settlement agreement. The court ultimately held that despite the appellant's "interest and participation in this Class Action prior to and after settlement, [the appellant] was not a named plaintiff in the Class Action; [the appellant's] posture as an unnamed Class member curtails its right to appeal."58

In holding as it did, the court stated that although the appellant "could have appealed the district court's approval of the Settlement Agreement under Research Corp., we decline to expand Research Corp.'s holding to allow the appeal of post-judgment orders by unnamed class members."59 Instead, the court found the reasoning in Guthrie to be more appropriate.60 First, the appellant represented its own interest rather than the interest of the class; and even if it did represent the class, there was no determination by the court that it protected the interests of the class as required by Rule 23(a).61 Second, allowing the appellant to appeal in this case would "wholly thwart the purpose behind class actions."62 Finally, the court recognized that the appellant had other avenues of relief.63

Following In re VMS Limited Partnership Securities Litigation, the Seventh Circuit was again confronted with the attempts of unnamed class members who had not intervened to appeal a district court's judgment. In In re Brand Name Prescription Drugs Antitrust Litigation,64 plaintiffs brought an antitrust class action against numerous manufacturers and wholesalers of pharmaceuticals. The district court granted summary judgment in favor of the wholesalers, which resulted in appeals from two groups of plaintiffs.65 One group consisted of previous class members who had opted out of the class action, and

58. Id. at 367.
59. Id. at 369.
60. The court stated in a footnote that it offered "no opinion on the merit of Guthrie's principle as applied to an unnamed class member who appeals the approval of a consent decree." Id. at 368 n.8. "That is not the issue in this case, and furthermore, Research Corp. still controls that issue in this circuit." Id. It should be noted that the court changed its view in Felzen when it stated that "the distinction is inconsequential for purposes of Rule 3(c), the rationale of Marino, and the rationale of Brand Name Prescription Drugs that the court should not 'fragment the control of the class action' by allowing class members to usurp the role of the class representative without persuading the district judge that the representative is unfit or unfaithful, or that subclasses should be created." Felzen v. Andreas, 134 F.3d 873, 875 (7th Cir. 1998)(citations omitted) (quoting In re Brand Name Prescription Drugs Antitrust Litig., 115 F.3d 458, 457 (7th Cir. 1997)).
61. See In re VMS Ltd. Partnership Sec. Litig., 976 F.2d 362, 368 (7th Cir. 1992).
62. Id.
63. See id. at 368-69. Although the court recognized that there were other avenues of relief, it did not specify them because it felt that the appellant had able counsel and because it did "not desire to encourage one or more avenues of alternative litigation." Id.
64. 115 F.3d 456 (7th Cir. 1997).
65. See id. at 457.
who had brought their own suits against the manufacturers but not the wholesalers. The other group consisted of unnamed class members. With regard to the opt-outs, the court essentially held that by opting out the appellants were no longer parties to the class action and thus fell directly under *Marino*, which requires nonparties to intervene before they can appeal.\(^6\) The court held that the other appellants could not appeal either because allowing them to do so would "fragment the control of the class action."\(^6\) The court held that unnamed class members must intervene before they will be allowed to appeal.\(^6\) In support of its holding, the court recognized four alternative avenues of relief available to unnamed class members who are unsatisfied with the representation of the class representatives. In addition to the three avenues of relief mentioned in *Guthrie*,\(^6\) the court stated that class members could "seek the creation of a separately represented subclass."\(^7\)

2. *Derivative Suits*

Unlike the situation where unnamed class members attempt to appeal a settlement agreement reached by the named parties and approved by the district court, there are only a few cases that deal with whether a nonparty shareholder can appeal a district court's approval of a settlement reached between the named parties. Before *Felzen*, there were really only three significant decisions. Each of these, contrary to *Felzen*, allowed a nonparty shareholder who had objected to the settlement to appeal the district court's approval of it.

The first in the line of cases was *Cohen v. Young*.\(^7\) There, a shareholder brought a derivative suit alleging illegal activity by some of the corporation's directors, officers, and employees. Eventually, the parties agreed on a settlement. In compliance with the notice requirement of what was then Rule 23(c),\(^7\) the court sent all the shareholders an "order to show cause why the proposed settlement should not be approved."\(^7\) In response to this notice, the appellant

\(^6\) See id.

\(^6\) Id. "If class members can file their own appeals, the coherence of the class is destroyed, the scope of the class action becomes unclear, and the control over the action becomes divided and confused." Id. at 458.

\(^6\) See id.

\(^6\) The three avenues of relief mentioned in *Guthrie* are as follows: (1) Class members can move to intervene as of right pursuant to Rule 24(a)(2) of the Federal Rules of Civil Procedure; (2) In the case of inadequate representation, the class member may pursue relief in a collateral proceeding; and (3) In a Rule 23(b)(3) action, the class member may opt-out of the class. See *Guthrie v. Evans*, 815 F.2d 626, 628-29 (11th Cir. 1987).

\(^7\) In re *Brand Name Prescription Drugs Antitrust Litig.*, 115 F.3d at 457-58.

\(^7\) 127 F.2d 721 (6th Cir. 1942).

\(^7\) See supra note 11 and accompanying text.

\(^7\) 127 F.2d at 723.
appeared to object to the settlement and filed a motion to intervene.\textsuperscript{74} The motion to intervene was denied, and the appellant made no attempt to appeal the denial.\textsuperscript{75} Instead, he appealed the final decree of the district court approving the settlement.\textsuperscript{76} Allowing the nonparty shareholder to appeal, the court stated that he was "like a defendant who is summoned by process of court and after an adverse ruling has the right to appeal."\textsuperscript{77}

A number of years later, the Seventh Circuit decided \textit{Tryforos v. Icarian Development Co.},\textsuperscript{78} in which a nonparty shareholder appealed the district court's approval of a settlement reached by the named parties. The issue in that case, however, was not whether the nonparty shareholder could appeal, but whether in fact he had objected.\textsuperscript{79} Relying on \textit{Cohen}, the court stated in a footnote that "[t]he law is clear that a non-party shareholder who appears, pursuant to a Rule 23.1 notice, to present objections to a proposed dismissal or settlement of a derivative action may appeal an adverse decision even though he has not been formally made a party to the action."\textsuperscript{80} The court also stated that "no such appeal may be taken by a shareholder who has failed to make such an appearance."\textsuperscript{81}

Although both of the previous cases were significant, they were not very helpful because the courts provided little explanation for their conclusions. This changed, however, in \textit{Bell Atlantic Corp. v. Bolger},\textsuperscript{82} when the Third Circuit faced the issue of whether a nonintervening, nonparty shareholder could appeal. The appellants were shareholders who had brought a separate derivative action in state court that would have been precluded by the settlement reached between the named parties in the case that was before the court.\textsuperscript{83} Following the district court's approval of the settlement over the appellants' objections, they appealed. In response, the plaintiffs argued that the appellants did not have standing to appeal because they were not named parties and did not intervene. However, the court disagreed.

\textsuperscript{74} \textit{See id.}
\textsuperscript{75} \textit{See id.} at 724.
\textsuperscript{76} \textit{See id.}
\textsuperscript{77} \textit{Id.} (quoting \textit{Pianta v. H. M. Reich Co.}, 77 F.2d 888, 890 (2d Cir. 1935)). Stated more directly, "an unnamed member of a derivative suit who has not been allowed to intervene may nonetheless have standing to appeal if the district court has haled him into court." \textit{Shults v. Champion Int'l Corp.}, 35 F.3d 1056, 1060 (6th Cir. 1994).
\textsuperscript{78} 518 F.2d 1258 (7th Cir. 1975). As discussed \textit{infra} Part II.B.2, this decision was overruled in \textit{Felzen}.
\textsuperscript{79} \textit{See id.} at 1263.
\textsuperscript{80} \textit{Id.} at 1263 n.22.
\textsuperscript{81} \textit{Id.}
\textsuperscript{82} 2 F.3d 1304 (3d Cir. 1993).
\textsuperscript{83} \textit{See id.} at 1306-07.
To answer the question before it, the court reviewed how other courts had answered the related question of whether unnamed class members may appeal a settlement agreement reached by the named parties. In doing so, the court noted in a footnote that they were not deciding "whether different rules apply to objector appellate standing in class and derivative suits." They did mention, however, that "one of the rationales offered in support of an intervention requirement cannot apply to derivative actions." This rationale is that Rule 23(b)(3) class members may opt out of the class and pursue their own actions, whereas shareholders are not given that option.

In support of its decision to allow the objecting shareholder to appeal without first intervening, the court held that "agency costs inherent in class and derivative actions" caution against creating obstacles to challenging derivative action settlement agreements. Agency costs result from "the divergence of attorneys' incentives from shareholder interests." Since shareholders bring a derivative action for the benefit of the corporation, the return for the individual shareholder, if any, will be in the form of increased share value. This increased value of the stock will normally be relatively small. Consequently, "the costs of policing [and monitoring the attorney and the settlement] typically outweigh any pro rata benefits to the shareholder." Accordingly, the shareholder is "neither well-situated nor adequately motivated to closely monitor and control the attorney." As a result, there is an increased risk that the plaintiffs' attorney and the defendants will reach a settlement that provides little benefit to the corporation while providing high fees for the attorney. This concerted effort between the plaintiffs' attorney and the defendant augments the situation by essentially circumventing the check that Rule 23.1 puts on settlement agreements: judicial approval. "In seeking court approval of their settlement proposal, plaintiffs' attorneys' and defendants' interests coalesce and mutual interest may result in mutual indulgence." Accordingly, the parties will tend to "spotlight the proposal's strengths and slight its defects." This works to eliminate

84. Id. at 1307-08 n.4.
85. Id.
86. See id.
87. Id. at 1309.
88. Id. at 1310.
90. See Bell Atl. Corp. v. Bolger, 2 F.3d 1304, 1309 (3d Cir. 1993).
91. Id.
92. Id.
93. See id. at 1310.
94. See id.
95. Id.
96. Id.
"the full benefit of the adversarial process." 97 "In such circumstances, objectors play an important role by giving courts access to information on the settlement's merits." 98

Because of their important role, the court held that objectors should be able to appeal without being required to intervene. Recognizing the potential problems with allowing nonparties to appeal without intervening, the court stated that "[t]he interests of fairness and adequacy in settling disputes should outweigh concerns that non-intervening objectors will render the representative litigation 'unwieldy.'" 99

In Rosenbaum v. MacAllister, 100 the situation presented for the court's review was slightly different than that of the cases above. There, both a class action and a derivative suit were brought against the defendants. 101 Eventually, the parties reached a settlement, and notice thereof was sent to the class members and the shareholders. 102 In response to the notice, the appellant, who was both a class member and a shareholder, appeared and objected only to the attorney's fees. 103 Nevertheless, the court approved the settlement. On appeal, the appellant, who at no time moved to intervene, argued that he had standing to appeal as both a class member and as a shareholder. 104

Before addressing the issue, the court noted that its decision in Gottlieb v. Wiles 105 established that a class member had to intervene before he could appeal the district court's approval of the settlement. 106 However, the court stated "that the most important rationales underpinning the rule that only intervenors may appeal the approval of the settlement itself do not apply to appeals of awards of attorney's fees and expenses to class counsel." 107 When the court allows just one unnamed class member to appeal the approval of a settlement, this postpones any benefit to the class members as well as the defendant's elimination of its liability. 108 The result is mitigated when the court allows an unnamed class member to appeal just the attorneys' fees. In that case, the only party affected would be the attorneys. 109 Thus, the court essentially separates the settlement por-

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97. Id.
98. Id.
99. Id. Essentially, the court was saying that the concern for agency costs outweighs the collective action concerns. See infra Part III.A.
100. 64 F.3d 1439 (10th Cir. 1995).
101. See id. at 1441.
102. See id.
103. See id.
104. See id.
105. 11 F.3d 1004 (10th Cir. 1993).
106. See 64 F.3d at 1442.
107. Id.
108. See id.
109. See id.
tion of the agreement from the attorney's fees portion, and promotes their separate treatment.

The court stated three reasons why a nonintervening class member should be allowed to appeal the award of attorneys' fees. First, the class representative is not in a good position to resist excessive fee requests by the plaintiffs' attorney since in many cases the lawyers recruit the class representative.¹¹⁰ Second, when notice of the settlement is sent out, it usually states only an "outside limit for attorney's fees," with the expectation that the attorney's fees will be set after considering the evidence and objections of the class members.¹¹¹ Accordingly, the court did not feel "that a class member who is satisfied with the settlement should have to intervene because of the possibility the court might award an unreasonable attorney's fee."¹¹² Finally, the opt out feature is not available to a class member unsatisfied with just the award of attorney's fees, because by the time the attorney's fees are determined, it is too late to opt out.¹¹³ The court then stated that "[t]he same considerations apply even more clearly in the context of a shareholders' derivative suit," when the nonparty shareholder wants to appeal only the attorney's fee portion of the settlement.¹¹⁴ Accordingly, the court allowed the shareholder/class member to appeal even though he failed to intervene. However, the court did not make clear whether it allowed him to appeal because he was a class member, because he was a shareholder, or because he was both.

The relevant cases leading to Felzen present two major themes.¹¹⁵ First, the trend in a growing number of courts is to require unnamed class members to intervene before they will be allowed to appeal. The courts reason that the intervention requirement prevents the "unwieldy" litigation problems that work to undermine the purpose of the class action mechanism. In addition, the option available to class members to opt out provides them with an alternative avenue of relief if they feel that the settlement reached by the representative is unfair.

¹¹⁰. See id.
¹¹¹. Id.
¹¹². Id. at 1443.
¹¹³. See id.
¹¹⁴. Id. In support of that statement, the court stated the following:
    There is no opt out possibility. The benefits of the settlement inure to the corporation and hence only indirectly to the shareholder. The attorneys for the named representative are entitled to a fair fee; but an appeal of the court's fee award – to be paid out of the corporate treasury – would seem not to delay the benefits of the settlement. Id. (footnote omitted).
¹¹⁵. It should be noted that the list of cases discussed in this section is far from exhaustive. There are numerous other cases, particularly in the class action area, that address the relevant issues. However, as these cases add little more than the listed cases, they are not discussed.
The second theme is that derivative actions present a different situation than do class actions. Like the situation in class actions, there is the possibility of "unwieldy" litigation if the ability of shareholders to appeal is unrestrained. However, shareholders that are dissatisfied with the representation in a derivative suit lack the option to opt out and are thus stuck with the settlement reached by the representative. Because of this lack of an alternative avenue of relief, the courts have determined that it should be easier for shareholders to appeal. Accordingly, there appear to be no cases that require shareholders to intervene before they can appeal the district court's approval of a settlement, that is, until Felzen.

B. Felzen

1. Facts

On June 28, 1995, the day after FBI agents raided the corporate headquarters of Archer Daniels Midland (ADM) and the homes of its top executives, ADM announced that it was the subject of three separate federal grand jury investigations, which were inquiring into whether ADM had conspired with rival businesses to fix the price of certain products.\(^{116}\) Eventually, ADM pled guilty to criminal antitrust charges and was required to pay a fine of $100 million.\(^{117}\) ADM also spent an additional $90 million to settle three civil antitrust lawsuits that were brought by its competitors.\(^{118}\) Shortly after the announcement of the grand jury investigations, numerous shareholders filed derivative actions against ADM's directors, alleging that they engaged in gross mismanagement by failing to properly supervise company employees.\(^{119}\) The plaintiffs' aim was to recover the $190 million that ADM was required to pay for the criminal antitrust violation fine and the civil action settlements.\(^{120}\) After six months of negotiation, the parties agreed to a settlement.\(^{121}\) Essentially, the plaintiffs' attorneys agreed to release any cause of action against ADM and the defendant directors in return for $8 million and an agreement to make various corporate governance reforms.\(^{122}\)

117. See id. at 3.
118. See id. at 6.
119. See id. at 5. The two actions that resulted in the present case were brought and then consolidated in Illinois. See Brief for Respondent (ADM) at 1-2, California Pub. Employees’ Retirement Sys. v. Felzen, 525 U.S. 315 (1999). Fourteen other actions were brought, and later consolidated, in Delaware, where ADM was incorporated. Id. at 2.
120. See Brief for Petitioners at 5.
121. See Brief for Respondent (ADM) at 2.
122. See Brief for Petitioners at 6-7. All of the eight million dollars was to be allocated to pay attorneys’ fees. Almost half of it was designated to plaintiffs’ attorneys.
As required by Rule 23.1, a notice of the proposed settlement was sent to the shareholders directing them to appear if they had any objections to the proposed settlement. In response to the notification, California Public Employees' Retirement System and Florida State Board of Administration, both shareholders who were not named in the derivative action, appeared to make their objections to the proposed settlement. The basis for their objections was that the settlement provided very little benefit to the corporation. The district court heard their objections along with those of five other shareholders, but nonetheless approved the proposed settlement. Without making any attempt to intervene, California Public Employees' Retirement System and Florida State Board of Administration appealed the district court's approval of the settlement.

2. Decision of the Seventh Circuit

The issue before the court was whether a nonparty shareholder who had not intervened, but who had appeared to object to a proposed settlement, could appeal the district court's approval of a settlement agreement that was reached between the named parties in the derivative action. Answering the question in the negative, the court rested its decision on two main grounds: the Supreme Court's holding in Marino and the requirements of Federal Rule of Appellate Procedure 3(c). Thus, this overview of the court's decision will be divided into two corresponding sections.

Marino Ground

Using Marino as the core of its analysis, the court undertook what was essentially a three-step process to conclude that a nonparty shareholder must intervene before she can appeal the approval of the settlement agreement by the district court. The first step the court took was to apply Marino to the situation where an unnamed class member fails to intervene, but nevertheless attempts to appeal the district court's approval of a class action settlement. The court then distinguished the position of an unnamed class member in a class action from that of a nonparty shareholder in a derivative action to conclude that a nonparty shareholder has a weaker claim with regard to the considerations that weigh against an intervention require-
The final step the court took was to conclude that since unnamed class members must intervene before they may to appeal, then nonparty shareholders, who have a weaker claim, should also be required to intervene before they can appeal a district court's approval of a settlement.\(^{129}\)

**Step One: Unnamed Class Members are Required to Intervene**

Judge Easterbrook began his opinion with a quote from *Marino*:

The rule that only parties to a lawsuit, or those that properly become parties, may appeal an adverse judgment, is well settled. The Court of Appeals suggested that there may be exceptions to this general rule, primarily "when the nonparty has an interest that is affected by the trial court's judgment." We think the better practice is for such a nonparty to seek intervention for purposes of appeal; denials of such motions are, of course, appealable.\(^{130}\)

The court interpreted those words to mean that "a person adversely affected by the settlement of a class action may appeal from the consent decree based on that settlement only if he has intervened as a party."\(^{131}\) However, the court also noted that, prior to *Marino*, it had "permitted class members and stockholders to appeal, whether or not they had intervened, provided they had informed the district court of their objections to the decision that disadvantaged them."\(^{132}\) With this in mind, the court was quick to point out that its holding in *Research Corp.*, which allowed the appeal of an unnamed class member who had appeared in court to object to the settlement, was no longer authoritative, especially in light of two of its more recent opinions. These two opinions, *In re VMS Limited Partnership Securities Litigation*\(^{133}\) and *In re Brand Name Prescription Drugs Antitrust Litigation*,\(^{134}\) both stood for the proposition that unnamed class members were required to intervene before they would be allowed to appeal.

The appellants argued that since *VMS* involved the appeal of a post-settlement order and *Brand Name* involved the appeal of a summary judgment, neither case applied to the situation before the court because neither dealt with an appeal from an approval of a settlement agreement. The court rejected this argument and stated:

[T]he distinction is inconsequential for purposes of Rule 3(c), the rationale of *Marino*, and the rationale of *Brand Name Prescription Drugs*: that the court should not 'fragment the control of the class action' by allowing class members to usurp the role of the class representative without persuading the district court.

\(^{128}\) See id. at 875-76.

\(^{129}\) See id.

\(^{130}\) Id. at 874 (quoting *Marino*, 484 U.S. at 304 (citations omitted)).

\(^{131}\) Id.

\(^{132}\) Id.

\(^{133}\) 976 F.2d 362 (7th Cir. 1992).

\(^{134}\) 115 F.3d 456 (7th Cir. 1997).
judge that the representative is unfit or unfaithful, or that subclasses should
be created.135

The court specifically overruled Research Corp. and any other case in
the circuit that would permit a nonparty to appeal "from a decision of
any kind in a class action."136

Despite the intervening precedent and the language of Rule 3(c),
the appellants argued that the rule set forth in Tryforos v. Icarian
Development Company137 should apply. In that case, the court stated
in a footnote that "a non-party shareholder who appears, pursuant to
a Rule 23.1 notice, to present objections to a proposed dismissal or
settlement of a derivative action may appeal an adverse decision even
though he has not been formally made a party to the action."138 The
court rejected this argument because the issue in that case was not
the same as the issue sub judice, and also because the support for that
court's statement was minimal.139 The Tryforos court cited only two
cases: one was a case from the 1940s that allowed nonparty appeals,
but did not give any reasons for its holding, while the other was a
district court case, which, as Judge Easterbrook stated, was "an odd
reference for a rule of appellate jurisdiction."140 Justifying the rejec-
tion, the court stated that "[a]n unexplained practice does not offer
shelter from a later opinion of the Supreme Court holding that only
parties may appeal, and withdrawing from the appellate courts any
exception-making power."141

The appellants also argued the rather basic point that "erroneous
decisions should be reversed."142 The basis of this argument was that
by necessitating the additional burden of intervention, shareholders
will be less likely to appeal. Accordingly, erroneous decisions of the
district court will go unreviewed. The court rejected this argument,
however, by simply stating that "[a] court of appeals is not an
ombudsman."143 This is essentially the fairness argument to which
the Bell Atlantic court deferred. The Felzen court was not swayed by
the reasoning that the possibility of an unfair settlement necessitates
making appeals easier.

135. 134 F.3d at 875 (citations omitted) (quoting In re Brand Name Prescription
Drugs, 115 F.3d at 457).
136. Id.
137. 518 F.2d 1258 (7th Cir. 1975).
138. Id. at 1263 n.22.
139. See 134 F.3d at 874.
140. Id.
141. Id.
142. Id.
143. Id.
Step Two: Distinguishing Class Actions and Derivative Actions

Following the determination that *Marino* required unnamed class members to intervene to appeal any kind of decision, the court proceeded to the second step of its analysis: to distinguish between shareholders and class members. Ultimately, the court found that as far as Rule 3(c) or *Marino* is concerned, there is no difference between a shareholder's derivative action under Rule 23.1 and a class action under Rule 23 that would permit appeals by nonparty shareholders.\(^\text{144}\)

Although the court recognized differences between a shareholder's derivative action under Rule 23.1 and a class action under Rule 23, it held that shareholders had a weaker claim toward allowing nonparty appeals. The main distinction the court recognized was that all class members are equally entitled to litigate, or in other words, each has a "real grievance with the defendant,"\(^\text{145}\) whereas in the shareholder derivative action, the "individual investor is not an injured party."\(^\text{146}\) The injured party in a derivative suit is the corporation. The investor bringing the action does so under the corporation's right to recover for an injury, not his own. The court held that this difference set up "at least an equitable argument for a class member who wants to appeal."\(^\text{147}\)

In support of its distinction between class members and shareholders and its conclusion that nonparty shareholders have the weaker claim, the court mentions two characteristics of corporations. First, when an investor invests in a corporation, she places her funds at the management's disposal.\(^\text{148}\) In return for this investment, she gets the right to choose future management. Thus, by investing in a certain corporation, the investor takes a risk, which is partially alleviated by the investor's role in selecting the future management. Second, derivative suits "do little to promote sound management and often hurt the firm by diverting the managers' time from running the business while diverting the firm's resources to plaintiffs' lawyers without providing a corresponding benefit."\(^\text{149}\)

In light of the distinctions between class members and shareholders and the characteristics of derivative suits and the corporate management structure, the court determined that nonparty shareholders

\(^\text{144. See id. at 875.}\)
\(^\text{145. Id. The court also recognized that "which injured persons become the representatives, and which the 'mere' class members is to a degree fortuitous and to a degree dependent on the entrepreneurial activity of the class counsel." Id.}\)
\(^\text{146. Id.}\)
\(^\text{147. Id.}\)
\(^\text{148. See id.}\)
\(^\text{149. Id. at 876.}\)
have a weaker claim for escaping the intervention requirement than do class members.150

**Step Three: Apply Rule for Class Actions to Derivative Suits**

Once the court had determined that nonparty shareholders had a weaker claim regarding the elimination of the intervention requirement, its final step was to apply the rule for unnamed class members in class actions to nonparty shareholders in derivative actions. Having a weaker claim, nonparty shareholders have an even less persuasive argument that intervention should not be a necessary predicate to an appeal. Accordingly, since class members are required to intervene, the court determined that nonparty shareholders should also be required to intervene before they will be allowed to appeal a settlement approved by the district court.

**Federal Rule of Appellate Procedure 3(c) Ground**

The second major ground on which the court based its decision was Federal Rule of Appellate Procedure 3(c). Rule 3(c) states that “[a] notice of appeal must specify the party or parties taking the appeal by naming each appellant in either the caption or the body of the notice of appeal.”151 The court quoted this language in the first paragraph of its opinion and referred to the rule several times as a basis for its decision. However, the court failed to explain how or why Rule 3(c) supported its decision.

The court’s reliance on Rule 3(c) as a basis for its decision was most likely taken from the Supreme Court’s opinion in *Marino*. In *Marino*, the Court cited the rule after it had determined that only parties to a lawsuit, or those that properly become parties, may appeal an adverse judgment.152 Thus, it appears that the Court used Rule 3(c) to support that statement. Again, however, the Court failed to explain how Rule 3(c) had any significance in determining whether a nonparty may appeal an adverse judgment. Since neither court explained its usage of Rule 3(c), it remains unclear how or why the rule supports either outcome.

**C. After Felzen**

Although the *Felzen* decision was fairly recent, at least one case has confronted a similar issue more recently. In *Kaplan v. Rand*,153 the court considered whether a nonparty shareholder who had objected, but failed to intervene, could appeal the district court’s ap-

150. See id.
151. FED. R. APP. P. 3(c)
152. See Marino v. Ortiz, 484 U.S. 301, 304 (1988).
153. 192 F.3d 60 (2d Cir. 1999).
The Second Circuit determined whether an objecting, nonparty shareholder may appeal by determining if the shareholder is “affected” by the settlement. “Although the general rule is that only a party of record may appeal a judgment, a nonparty may appeal ‘when the nonparty has an interest that is affected by the trial court’s judgment.’” Accordingly, the court found that because the payment of attorney’s fees out of the corporate funds affected “the well-being of the corporation,” the interests of all the shareholders were affected. As a result, it allowed the nonparty shareholder to appeal without intervening.

In rejecting the application of Felzen, which the plaintiffs’ attorneys urged the court to accept, the court noted that Felzen was based primarily on Marino. Accordingly, to get around Felzen, the court attacked its foundation, Marino. The court first distinguished Marino by noting that, unlike the nonparty shareholder sub judice, the appellants in Marino were not affected by the settlement.

Thus, this court seems to feel that the “better practice” language in Marino indicates a preferred practice rather than a required one.

III. EFFECTS OF INTERVENTION

As seen from the review of the cases dealing with the appeals of nonparty shareholders that have failed to intervene, Felzen goes against all of these by requiring intervention. Although the method by which the court reached this conclusion is subject to a great deal of

\[\text{154. See id. at 60.}\]
\[\text{155. See id. at 67.}\]
\[\text{156. Id. (quoting United States v. International Bd. of Teamsters, 931 F.2d 177, 183-84 (2d Cir. 1991)).}\]
\[\text{157. Id.}\]
\[\text{158. Id. at 67-68.}\]
\[\text{159. See id. at 68. For a discussion of Marino, see supra Part II.A.1. The court noted that the appellants in Marino would not have been entitled to a promotion even if the settlement were invalidated. Consequently, they did not have an interest that was affected by the settlement. See id.}\]
\[\text{160. Id.}\]
criticism,161 this note argues that its ultimate holding is correct. This note focuses not on the analysis the court undertook to reach its holding, but rather on the practical effect of the court's holding on derivative litigation. This section will first discuss the major problems that accompany class and derivative actions. It will then set forth the argument that has been used by most courts and commentators to support the rule that requires only that nonparty shareholders object to the settlement before they will be allowed to appeal. The third section will illustrate the problems with that argument and show why an intervention requirement will result in a more preferable outcome.

A. The Problems of the Derivative Action

Before any solution to the problems inherent in derivative actions can be addressed, it is first necessary to understand the problems. Although the class and derivative actions have the same problems, the different rules governing each type of action require separate analysis. This note will focus on the solution to those problems in the derivative action context. There are two main problems that arise in both class and derivative actions. One involves the agency costs associated with the settlement of those suits, and the other involves the problems stemming from collective actions.

Agency costs are those costs resulting from the "divergence of attorneys' incentives from shareholder interests."162 As the Bell Atlantic court mentioned, these costs occur because of the lack of incentive and motivation of the shareholder to monitor the attorney.163 This lack of incentive and motivation stems from the fact that the costs of monitoring will most likely exceed any benefit the shareholder will receive from the settlement.164 This is because the benefit of monitoring the attorney will be spread out amongst all the shareholders, while the costs of monitoring will be borne by the individual shareholder that does the monitoring.165 Without any monitoring by the shareholder, the attorney will likely pursue her own interests rather


162. Romano, supra note 89, at 69.


164. See Bell Atl. Corp., 2 F.3d at 1309.

165. See Macey & Miller, supra note 163, at 19-20.
than that of the shareholders.\textsuperscript{166} Accordingly, the attorney will likely reach a settlement with the defendants that provides little benefit to the corporation and significant benefit to the attorney.\textsuperscript{167} The agency costs represent the difference between the benefits the corporation would have received under the settlement had the attorney's interest been aligned with the shareholders and the benefit the corporation actually received. This is one of the major problems of not only derivative actions, but class actions as well.

There is one important feature available to class members in class actions that is not available to shareholders in derivative suits.\textsuperscript{168} This feature is the rule that unnamed class members may opt out of the class if they for some reason do not want to be part of it.\textsuperscript{169} "Any class members who choose to opt out will not be bound by any judgment or settlement that is reached in the case."\textsuperscript{170} Accordingly, this device works as a check on the plaintiff's attorney by providing class members with the option to exclude themselves from the effect of any settlement proposed by the attorney.\textsuperscript{171} As a result, the problems of agency costs are reduced. This option, however, cannot be used by shareholders who wish to exclude themselves from the binding effects of a settlement reached in a derivative action.\textsuperscript{172} The only way shareholders can avoid the effects of the settlement is to "terminate their interests in the corporation."\textsuperscript{173} For obvious reasons, this is not an adequate safeguard.

The second problem, also common to both derivative and class actions, results from the characteristics of collective actions. "Collective action refers to activities that require the coordination of efforts by two or more individuals."\textsuperscript{174} Problems with collective actions arise when free-riders partake in the settlement with the group, but sepa-

\begin{itemize}
  \item \textsuperscript{166} See id. at 22-27.
  \item \textsuperscript{167} See, e.g., John C. Coffee, Jr., Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 COLUM. L. REV. 669, 677 (1986) (stating that "such actions are uniquely vulnerable to collusive settlements that benefit plaintiff's attorneys rather than their clients"); Macey & Miller, supra note 163, at 44-45 (recognizing the different ways in which an attorney may benefit under the different compensation schemes).
  \item \textsuperscript{168} Compare Fed. R. Civ. P. 23(c)(3) (stating that in a class action maintained under subdivision (b)(3), "the court will exclude the member from the class if the member so requests"), with Fed. R. Civ. P. 23.1 (failing to provide the shareholder in a derivative suit the same option).
  \item \textsuperscript{169} This feature is only available in class actions brought under Fed. R. Civ. P. 23(b)(3). See, e.g., Gottlieb v. Wiles, 11 F.3d 1004, 1011 (10th Cir. 1993) ("Rules 23(b)(1) and (b)(2) do not have an opt-out provision.").
  \item \textsuperscript{170} Kim, supra note 161, at 117.
  \item \textsuperscript{171} See id.
  \item \textsuperscript{172} See id. at 118.
  \item \textsuperscript{173} Id.
  \item \textsuperscript{174} Id. at 133.
\end{itemize}
rate from the group once separation becomes more beneficial than participation. Essentially, the free-riders reap the "benefits of other members' adherence to the collective decision while disregarding that decision themselves."175 In the settlement context, collective action problems will arise when individual, free-riding class members or shareholders are free to appeal a settlement reached by the group. The appeal by free-riders "makes settlements more costly and increases the likelihood that settlements will be more difficult to finalize."176 Thus, when there are no restraints on the appeal of free-riders, settlements can be significantly hampered.

B. Theoretical Solution to the Problems

When considered theoretically, as most commentators and courts have in fact done,177 the best solution to these problems, they argue, is to allow objecting, nonparty shareholders to appeal a district court's approval of a settlement without requiring them to intervene.178 Essentially, they have decided that reducing the agency costs is more important than collective action concerns. This section describes the basis for their conclusion.179

The argument starts by recognizing the consequences of allowing appeals by nonparty shareholders who object to a settlement. With appeals made easier than they otherwise would be if intervention were required, the plaintiffs' attorneys will recognize that there is a greater chance that their settlement will be appealed. "As appeals become less difficult to bring, these attorneys will be less inclined to enter into unmeritorious settlements that can easily be upset on appeal by objecting shareholders."180 Thus, the attorneys will be more likely to reach a settlement more favorable to the shareholders, which in turn will reduce agency costs. At the same time, however, collective action problems will be intensified. By making appeals easier to

176. Kim, supra note 161, at 134.
178. See supra note 177.
179. Although the argument is not specifically stated by the courts and other commentators that subscribe to the argument, the basics of it are set forth in a brief, well-written fashion in Kim, supra note 161, at 132-34. Accordingly, only this article will be cited in support of their argument. However, it should be reemphasized that the courts and commentators listed in note 177 all support the argument.
180. Kim, supra note 161, at 133 (emphasis added).
bring, it then becomes easier for free-riding shareholders to appeal an otherwise beneficial settlement.

If individual shareholders in derivative suits know that they can each gain the right to appeal so long as they appear at the settlement hearing and object, they may be tempted to do so and thus "defect" from the group settlement at a rate much higher than would have been the case without such a rule. As a result, the removal of barriers to appeal makes settlements more costly and increases the likelihood that settlements will be more difficult to finalize.\textsuperscript{181}

If, on the other hand, courts required intervention before a non-party shareholder could appeal, the opposite result would be reached. Agency costs would increase because plaintiffs' attorneys would realize that this additional burden decreases the likelihood that a non-party shareholder will appeal the settlement, thus giving the attorneys a greater opportunity to reach settlements that benefit themselves more than the shareholders. The collective action problems, however, would be reduced. "Because fewer shareholders will be inclined to take on the burden of formally intervening in the lawsuit, proposed settlements will be much less likely to meet with opposition. This reduces the costs of finalizing a settlement and contributes to a quick and efficient resolution of the action."\textsuperscript{182}

Since both alternatives have advantages and disadvantages, the question then becomes which alternative provides the greatest benefit. The courts and commentators that support the described argument conclude that allowing objecting shareholders to appeal produces the most desirable results. "[A]lthough there is a price for adopting a rule that requires only objections to preserve appellate rights in derivative suits, the corresponding benefits of reducing agency costs, decreasing the risk of collusive arrangements, and ensuring fair and adequate settlements make the price worth paying."\textsuperscript{183}

\textbf{C. Practical Solution to the Problems}

The argument set forth above makes sense in theory. However, when one examines the practical realities surrounding the derivative suit and the appeal of a settlement, a rule requiring intervention before a nonparty shareholder may appeal a settlement avoids both problems described above.

The justification for the objection requirement in the argument above was that, even though it increased the likelihood of collective action problems, it reduced agency costs. The argument that it re-

\textsuperscript{181} Id. at 133-34.
\textsuperscript{182} Id. at 134.
\textsuperscript{183} Id. Again, the Kim article is cited because it provides the best description of the argument. The courts and the other commentators cited in note 177 have all implicitly reached the same conclusion.
duced agency costs was premised on the belief that a plaintiff's attorney who knows that his settlement "can easily be upset on appeal by objecting shareholders" would have an incentive "to create valid settlements that reflect the true value of the suit." Similarly, the intervention requirement was criticized because it would increase agency costs by providing an additional barrier to non-party shareholders wishing to appeal the plaintiff's attorney's settlement. Knowing that appeals are less likely, the attorney would be more inclined to reach a settlement that benefits herself rather than her client.

These arguments are based on one important premise: that plaintiffs' attorneys will tailor their behavior based on how easy it is for nonparties to appeal. While this premise makes sense in theory, it does not hold up in practice. In reality, even without the intervention requirement, it is highly unlikely that a district court's approval of a settlement will be overturned on appeal. With this fact known by the plaintiff's attorney, it is unlikely that the addition of this relatively slight procedural burden will have a significant effect on how the plaintiff's attorney structures the settlement. Thus, whether or not intervention is required before a nonparty shareholder may appeal will have no effect on the attorney, since she will think it unlikely in either case that the appellate court will overturn the district court's approval of the settlement. Consequently, either rule will result in the same agency costs. Since neither rule provides any greater reduction in agency costs than the other, the most beneficial rule would be the one that reduces the collective action problems. Accordingly, requiring nonparty shareholders to intervene before they may appeal is the more desirable rule.

There are essentially two reasons why success at the appellate level is unlikely. First, appellate courts "review the district court's approval of a [settlement reached in a] shareholder's derivative lawsuit for abuse of discretion." Under the abuse of discretion standard, "only if an appellate court is convinced that the court below was clearly wrong will it reverse a discretionary decision." Furthermore,

discretion ... is abused when the judicial action is arbitrary, fanciful or unreasonable, which is another way of saying that discretion is abused only where no reasonable man would take the view adopted by the trial court. If reasona-

184. Id. at 133 (emphasis added).
185. Id.
186. When compared with the tremendous obstacles that an appellant must overcome to get a favorable judgment once she is allowed to appeal, the additional burden of the intervention requirement is insignificant.
ble men could differ as to the propriety of the action taken by the trial court, then it cannot be said that the trial court abused its discretion.\(^{189}\)

Thus, it appears that unless a district court's approval of a settlement is completely unfounded, it will not be overturned on appeal.

The second reason that success on appeal is unlikely is the tendency of judges to favor settlements. "In deciding whether to approve this settlement proposal, the court starts from the familiar axiom that a bad settlement is almost always better than a good trial."\(^{190}\) One commentator went so far as to state that "[a] judge faces virtually no prospect of reversal for approving a settlement."\(^{191}\) Thus, when the tendency of judges to favor settlements is combined with the discretion a reviewing court gives to the district court when it approves a settlement, it is highly unlikely that a settlement will be overturned on appeal.

IV. BENEFIT TO THE CORPORATION

In light of modern protection for corporate officers, the appeal of a settlement is likely to hurt the corporation rather than help it. Thus, a rule that reduces the number of appeals by requiring intervention will benefit the corporation.

Two benefits may arise from the commencement of derivative actions. "First, [a] successful suit may confer monetary benefits on shareholders: corporations may recover damages from errant managers for past harms and undo or avert corrupt transactions. Second, suit – or, more precisely, the prospect of suit – can add to corporate value by deterring wrongdoing."\(^{192}\) However, both of these benefits have essentially been undermined by practices that ultimately result in the corporation paying the director's or officer's liability,\(^{193}\) rather than the wrongdoing director or officer paying it themselves.\(^{194}\) Since the corporation essentially pays for the liabilities of the wrongdoing directors and officers, it in effect pays itself and therefore receives no

\(^{189}\). Delno v. Market St. Ry. Co., 124 F.2d 965, 967 (9th Cir. 1942).


\(^{191}\). Macey & Miller, supra note 163, at 46.


\(^{193}\). "Many large corporations have adopted by-laws authorizing . . . indemnification to the full extent permitted by law, and virtually every corporation listed on a national securities exchange purchases liability insurance for its corporate officials covering . . . legal expenses." Coffee, supra note 167, at 677. Thus, the corporation, and ultimately the shareholders, pay for the corporate official's liabilities whether it be through indemnification or through insurance premiums.

\(^{194}\). See Tim Oliver Brandi, The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action, 98 Dick. L. Rev. 355, 387-88 (1994) (recognizing that "individual defendants can settle the case with other people's money."); Romano, supra note 89, at 62 ("the vast majority of settlements are paid by D & O insurance" for which the shareholders bear the cost).
monetary benefit. At the same time, it can hardly be said that the directors and officers are deterred when they are required to pay nothing. Although the details of these practices are beyond the scope of this note, they are worth mentioning to show how little benefit the derivative suit derives to the shareholder, especially when nonparty shareholders appeal. Derivative suits just cost the corporation more money. In fact, the only parties that really benefit from derivative litigation are the attorneys. 195

V. CONCLUSION

Although the basis for the court’s decision in *Felzen* is subject to criticism, its ultimate holding that nonparty shareholders are required to intervene before they can appeal the district court’s approval of a settlement produces the more beneficial result for the corporation. In light of the fact that most corporations either indemnify or insure their corporate officers, the derivative suit provides little benefit to the corporation. As a result, the corporation pays for the defendants’ liabilities and for the attorneys’ fees. Thus, when the parties to a derivative suit reach a settlement, it only harms the corporation more when the settlements are appealed. The appeal will only result in more attorneys’ fees, without providing any corresponding benefit to the corporation. This is especially true when one considers how unlikely it is that a settlement will actually be overturned on appeal.

All of these factors indicate that a rule reducing the number of worthless appeals will result in the most favorable outcome for the corporation. The rule requiring intervention before shareholders can appeal offers more of a deterrent effect than the rule allowing objecting shareholders to appeal. In addition, the former will result in virtually the same agency costs as the latter, while at the same time providing greater protection from collective action problems. In sum, the intervention rule will provide the greater protection from the problems inherent in derivative actions and will minimize the loss to the corporation.

195. See Romano, supra note 89, at 84 (“The principal beneficiaries of the litigation therefore appear to be attorneys, who win fee awards in 90 percent of settled suits”).